

# ELEMENTS OF THE GENERAL FUND FORECAST

## ASSUMPTIONS REGARDING THE ECONOMIC ENVIRONMENT

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### Overview

This document provides three alternative Five-Year Forecast scenarios for General Fund revenues and expenditures: Base Case, Optimistic Case, and Pessimistic Case. The Base Case is considered the most likely projection and that which the Administration recommends be used to formulate the 2008-2009 Proposed Operating Budget. Given the uncertainties inherent in any five-year forecast, however, two alternative case forecasts for the General Fund are also provided. These scenarios attempt to model the potential impact of more optimistic and pessimistic views of the future economic environment as well as the impact of offering different salary packages.

- ❑ **Base Case** – The Base Case forecast is built on the assumption that the current economic slowdown and problems associated with the housing market will dampen economic growth in San José. The impact on this region, however, is expected to be less severe than in other regions in California and the nation as a whole. As a result, the Base Case projects sustained, but slow, growth in General Fund revenue collections over the forecast period.
- ❑ **Optimistic Case** – In the Optimistic Case, it is assumed that the local housing market is stronger than in the base scenario as a result of a recovery spurred by lower than expected interest rates. The housing market strength affects Property Tax directly through higher valuations and Sales Tax indirectly through higher consumer confidence and borrowing power. The Optimistic Case also assumes that costs will be contained by reducing the salary increases by 1% from the growth rate assumed in the Base Case in the last four years of the Forecast.
- ❑ **Pessimistic Case** – The Pessimistic Case, alternatively, attempts to model the potential outcome of a continued severe drop in home prices and home resale activity, which negatively impacts Property Tax and Sales Tax growth. Salary increases are also 1% higher than those in the Base Case in the last four years of the Forecast.

### Base Case Forecast

As with all forecasts, this one is based on a series of assumptions regarding the overall economic environment, now and in the future. These assumptions were reached after reviewing the projections included in a number of economic forecasts. The economic conditions and the projected impacts on City revenues will continue to be closely monitored and any new developments will be factored into the City Manager's 2008-2009 Proposed Operating Budget, scheduled to be published on May 1, 2008.

The following is a discussion of both the national and local economic outlooks used to develop the revenue estimates for the Base Case Forecast. The revenue forecast is largely based on the national and State economic forecasts produced by the Anderson School of Management at UCLA. The City also uses an economic forecasting consultant to assist in the development of this forecast, particularly the modeling of the growth in the out years of the Forecast.

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## **ASSUMPTIONS REGARDING THE ECONOMIC ENVIRONMENT (CONT'D.)**

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### **National/California Outlook**

The national economy is expected to experience slower growth in 2008 than in 2007, particularly in the earlier parts of 2008. It is currently anticipated that the U.S. economy will approach recession levels next year but will not actually experience true recession conditions. The declining housing market remains the primary driver for the slowing economy and these problems are expected to persist through 2008. At this time, many economists predict that the current housing market slowdown will last several years.

The current condition of the financial markets also remains a major cause for concern. The mounting housing foreclosures are translating into a rapidly rising number of loan defaults. The high level of uncertainty surrounding the size of the loan defaults is undermining confidence in the financial markets. Now, an even greater threat is emerging in the form of questions regarding the solvency of the consumer and corporate debt markets.

Another problem for the economy is the energy market, most notably oil. In real terms, the current oil prices are at the highest levels since the 1970's. Gasoline prices are now approaching the \$4 per gallon mark in some parts of the country.

The negative impacts associated with the housing, financial, and energy markets are somewhat offset by the impact of a still expanding world economy, most notably the economies of the world's most rapidly developing countries in Asia. China, India, and other Asian economies are still on a rapid expansion path and this Forecast presumes they will continue to expand through the five years included. As these economies develop, they should continue to import a great many products from the United States. Stronger American exports translate into more jobs and more profits for American exporting businesses.

Also helping the American economy is the falling dollar, which makes U.S.-made goods less expensive when purchased abroad. Exports from the U.S. are up sharply and are on a trend towards continued increases. These exports are proving to be a shot in the arm for many previously struggling American businesses.

The longer-term outlook will, however, be heavily impacted by a continuing energy crisis that will begin to ease only in the out years of this Forecast. It is presumed that, by then, a turnover in American auto fleet to more fuel-efficient cars, increased production of alternate fuels, and greater energy efficiency will begin to offset very high oil prices.

### **Santa Clara County/City of San José Outlook**

Consistent with the national outlook, the severe slowdown in the housing market is expected to negatively impact this region. It is anticipated, however, that the local economy will fare better than the national economy.

This region is also expected to continue to benefit from defense spending as the defense industry has grown more dependent on high tech gadgetry designed and manufactured in this area. High

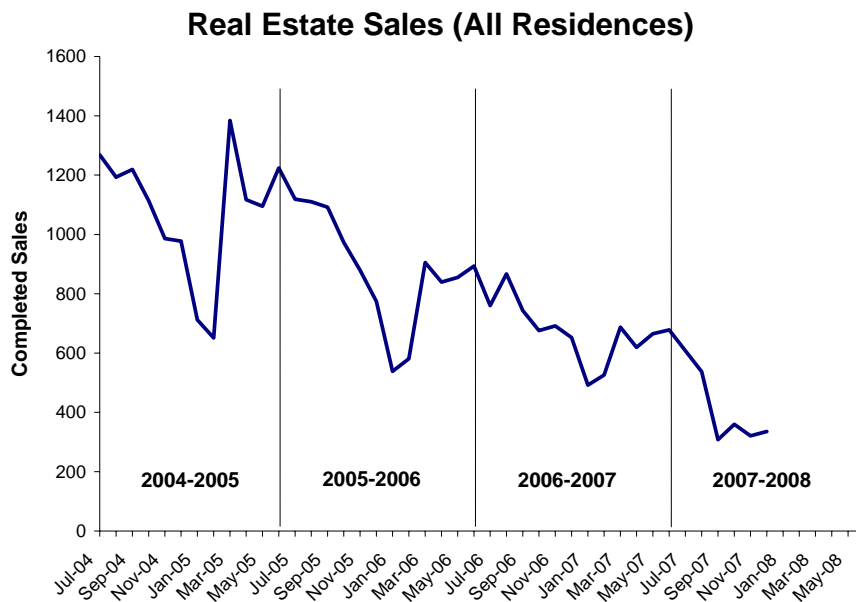
# ELEMENTS OF THE GENERAL FUND FORECAST

## ASSUMPTIONS REGARDING THE ECONOMIC ENVIRONMENT (CONT'D.)

### Santa Clara County/City of San José Outlook (Cont'd.)

energy prices and climate change are also adding fuel to the local economy. Much of the recent new venture capital money invested in Silicon Valley is for high tech applications in the energy generation and conservation fields. While not yet a huge source of employment for the economy, the fact that global warming has taken on a much more prominent political position suggests a continued flow of funds into the Valley for the funding of new startups. In addition, the expanding world economy helps this region. China is leading this growth with a continuing strong demand for American high tech goods. Thus, the demand for Santa Clara County high tech goods is expected to remain strong.

While there are areas that are positive, the slowdown in the housing market dominates current conditions and is expected to directly and negatively impact a number of the City's revenue sources, including Property Tax and Construction and Conveyance Taxes. The slowdown in this area can be expected to indirectly impact Sales Tax collections with the downward spending in construction materials and the reduction of consumer spending as the "wealth effect" associated with housing appreciation diminishes. As shown in the chart below, the number of housing sales in San José has dropped significantly in the last year.



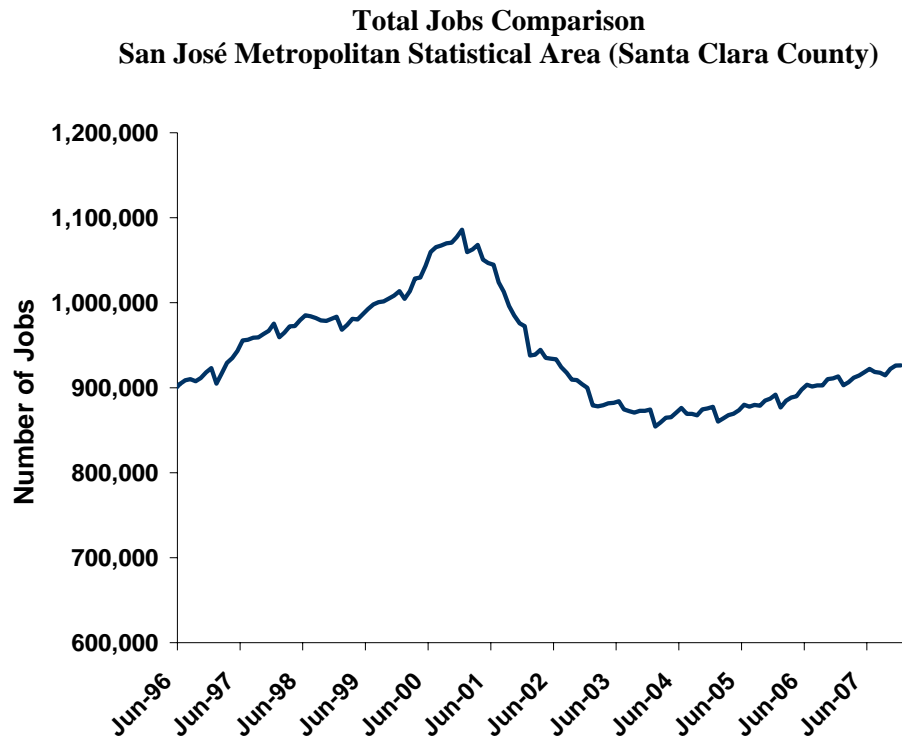
In the area of job growth, the employment figure for December 2007 (926,400) was 1.4% above the December 2006 figure of 913,400 jobs. This growth rate is tracking slightly below the job growth of 2.1% experienced in 2006-2007, indicative of a slowing in the local economy. The following table illustrates the changes in the number of jobs by fiscal year from the peak in 2000-2001 of 1.1 million jobs to the December 2007 figure of 926,400 jobs.

# ELEMENTS OF THE GENERAL FUND FORECAST

## ASSUMPTIONS REGARDING THE ECONOMIC ENVIRONMENT (CONT'D.)

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### Santa Clara County/City of San José Outlook (Cont'd.)



The unemployment figures also continue to inch upwards. The unemployment rate of 5.1% in December 2007 was slightly above the November 2007 figure of 5.0% but was up from 4.1% a year ago. This unemployment rate was below the unadjusted figure for the State of 5.9%, but above the unadjusted figure for the nation of 4.8% in December 2007.

In summary, for the next five years that constitute this forecast, Santa Clara County can expect to see lower growth than it has over the last several years, although this growth rate is expected to outpace that of the country as a whole. As a result, the General Fund Forecast assumes that during the forecast period the City will experience very modest levels of revenue growth. As explained elsewhere in this forecast document, the projected revenue growth levels are not sufficient to match the higher expenditure growth levels anticipated during the same period. The result is another General Fund Forecast projecting persistent shortfalls in the General Fund in all but one year of the forecast period.

### Economic Drivers

The 2009-2013 Base Case Forecast was built utilizing the following specific economic assumptions:

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## **ASSUMPTIONS REGARDING THE ECONOMIC ENVIRONMENT (CONT'D.)**

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### **Economic Drivers** (Cont'd.)

- The National Gross Domestic Product will grow 3.2% in 2008-2009, 3.0% in 2009-2010, 3.2% in 2010-2011, 3.3% in 2011-2012, and 3.5% in 2012-2013.
- The prime rate will range from a low of 7.7% in 2008-2009 to a high of 8.2% in 2011-2012.
- Mortgage rates will remain at relatively stable levels over the period, ranging from 7.7% in 2008-2009 to 8.2% in 2011-2012.
- The national unemployment rate will remain relatively stable at 5.2% in 2008-2009, and dropping slightly to 5.0% in 2009-2010, 4.75% in 2010-2011, 4.5% in 2011-2012, and 4.4% in 2012-2013.
- National employment will grow slowly over the forecast period, with growth of 1.12% in 2008-2009 and increasing slightly in the out years, with an average increase of 1.28% over the period.
- The County unemployment rate will track slightly below the national level, averaging 4.38% over the forecast period, with a low of 4.04% in 2012-2013 and a high of 4.78% in 2008-2009.
- Total County employment growth rates will remain stable with an average of 1.66% over the forecast period.

### **Optimistic and Pessimistic Scenarios**

As discussed above, all forecasts are burdened with a large degree of uncertainty, which increases going further into the future. As a result, in addition to the Base Case, two alternate, but plausible, revenue forecast scenarios are also presented in this document: an Optimistic Case and a Pessimistic Case. These alternatives were developed to display the range of possible outcomes over the next five years under varying economic conditions. The Base Case is, however, still considered the most likely outcome. The scenarios presented were created using specific sets of differing economic and political assumptions.

#### ***Optimistic Case***

In the Optimistic Case, it is assumed that the local housing market is stronger than in the base scenario. This stronger housing market is the result of lower than expected interest rates and perhaps other actions taken by the federal government to shore up the sagging housing market. The housing market strength affects property taxes directly through higher valuations and sales taxes indirectly through higher consumer confidence and borrowing power.

Local employment is also much stronger in this Optimistic Case. A decline in the value of the dollar that is greater than that assumed in the Base Case would cause a surge in the demand for local high tech products and thereby increasing the employment forecast. Also, the generally

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## ASSUMPTIONS REGARDING THE ECONOMIC ENVIRONMENT (CONT'D.)

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### **Optimistic and Pessimistic Scenarios** (Cont'd.)

stronger U.S. economy that is assumed under this scenario causes a greater increase than expected in the demand for high tech equipment also aiding local employment. The higher revenues result in increased government spending which, in turn, results in higher employment.

Later in the Forecast period of the Optimistic Case, increases in employment are being driven by the natural innovative cycle characteristic of the County's businesses. This means much greater than expected investment by venture capital, more startups and consequently more hiring.

At the end of the Forecast period, total revenues are \$26.0 million above the Base Case. The Sales Tax and Property Tax categories experience the largest gains in this scenario, with increases totaling \$22.7 million. Sales taxes are over 4% higher than the Base Case in the final year of the forecast. Property taxes are almost 7% higher. Stronger hotel room taxes and increased business license receipts also add to the revenues in this scenario.

### ***Pessimistic Case***

In the Pessimistic Case, both home prices and home resale activity are much lower than in the Base Case but home prices, in particular, are quite a bit lower. Typically, when home prices fall consumer confidence tends to fall with it, as does their ability to borrow in the home equity markets. Both of these events would have a significant impact on both property and sales taxes.

Local employment, one of the most important variables affecting local revenues, also falls in each year of this scenario. Lower local employment results from decreased demand for high tech goods at the national level and a lack of any significant innovation from the County's businesses. Lower employment growth rates could also result from higher than expected merger activity, off-shoring, and increasing State budget deficits which affect local government employment.

By the end of the Forecast period, total revenues are \$63.0 million below the Base Case. Sales Tax collections are almost 8% below the Base Case while property taxes are over 9% below the Base Case projection.

### **Impact of Forecasted Economic Conditions on Revenue Collections**

The economic conditions discussed above are the primary drivers for approximately half of the City's General Fund revenues, with the most significant impacts in the Sales Tax and Property Tax categories. The remaining areas, however, while impacted by overall economic performance, are primarily driven by other factors. For example, the Utility Tax and Franchise Fee categories are much more heavily impacted by utility rate changes and energy prices than economic growth. Collections in the Fines, Forfeitures, and Penalties category remain relatively flat under all economic conditions, while collections from local, State, and federal agencies are primarily driven by the grant and reimbursement funding available from these agencies. In the cost-recovery fees and charges programs, revenue collections must be directly linked to costs

# **ELEMENTS OF THE GENERAL FUND FORECAST**

## **ASSUMPTIONS REGARDING THE ECONOMIC ENVIRONMENT (CONT'D.)**

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### **Impact of Forecasted Economic Conditions on Revenue Collections** (Cont'd.)

with the result that the General Fund experiences no net gain or loss in times of an economic expansion or slowdown, respectively. Because these revenue sources do not track directly with the performance of the economy, the growth in these areas, even in times of economic strength, can hold down the City's overall revenue growth. Conversely, in an economic slowdown, these categories can act as a buffer, easing the impact of drops in the economically sensitive categories.

# **ELEMENTS OF THE GENERAL FUND FORECAST**

## **REVENUE FORECAST**

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Consistent with past forecast methodologies, the first year of the revenue forecast (2008-2009) was prepared in a manner similar to the preparation of the base budget revenue estimates. Over 500 revenue sources were examined to estimate the outcome in 2007-2008 and, building upon those projections, revenue estimates for 2008-2009 were developed. These revenue estimates will be closely examined and updated again during the development of the 2008-2009 Proposed Operating Budget.

As displayed in the Forecast, revenues (exclusive of Beginning Fund Balance) are shown to increase from \$801.7 million in 2008-2009 to \$891.0 million in 2012-2013, for an average growth rate of 2.78% per year. This growth rate is consistent with the last Forecast presented in February 2007.

Understanding the basis for the revenue estimates included in this Forecast requires discussion of the assumptions used for estimating each of the revenue categories. The following discussion focuses on estimates used for the 2008-2009 General Fund Forecast.

### **Property Tax**

Property Tax receipts of \$200.9 million are projected for 2007-2008, which represents growth of 5.9% over the prior year. This growth reflects increases in both the Secured and Unsecured categories, offset by a decrease in the SB 813 (property resales) collection area. In 2008-2009, the overall rate of growth is expected to slow to 3.8% to a total collection level of \$208.6 million. In the out years of the Forecast, annual growth is expected to range from a low of 4.3% in 2009-2010 to a high of 6.7% in 2012-2013. These projected growth rates are far below those experienced in recent years and reflect the impact of the significant slowdown in the housing market. Additional information about each of the Property Tax sub-categories is provided below.

Secured Property Taxes account for approximately 90% of the revenues in this category. In 2008-2009, Secured Property Tax growth will be driven by annual growth in the property tax roll. The 2008-2009 Secured Property Tax levy will be based on real estate activity in calendar year 2007. The residential real estate market experienced a significant slowdown in 2007, with a 32% drop in the number of single family homes sales in San José and the leveling off of the median home price. Secured Property Tax roll growth of 5.5% is projected for 2007-2008 based on preliminary information from the County of Santa Clara. This would bring Secured Property Tax collections to \$192.9 million in 2008-2009. It should be noted that final data on the actual tax levy for 2008-2009 is not available as adjustments are made through July 1, 2008. Updated information on the growth in the tax roll should be available for the development of the 2008-2009 Proposed Operating Budget, which will allow for further refinement of the growth estimate in this category.



# ELEMENTS OF THE GENERAL FUND FORECAST

## REVENUE FORECAST (CONT'D.)

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### **Property Tax** (Cont'd.)

Unsecured Property Taxes are the second largest revenue source in this category. Growth in this category is driven primarily by increases in the value of personal property (e.g. equipment and machinery used by business and industry for manufacturing and production). During the last decade, performance in this category has been extremely volatile with annual growth or declines reaching double-digit levels based primarily on the strength of the local business sector. Collections are expected to increase 3.5% in 2007-2008 to \$11.0 million. This collection level is also projected for 2008-2009.

SB 813 Property Taxes (supplemental taxes) represent payments for taxes owed on recent housing resales. With the significant drop in the number of housing resales, collections are expected to fall from the extremely high level of \$8.0 million in 2006-2007 to \$6.0 million in 2007-2008. Collections are projected to fall an additional 40% to \$3.6 million in 2008-2009 based on the assumption that the housing market will continue to experience steep declines through 2008-2009.

All other property taxes (Homeowners Property Tax Relief and Agricultural Tax Relief) are assumed to have little or no growth in 2008-2009, consistent with historical trends.

### **Sales Tax**

The Sales Tax category includes General Sales Taxes and Proposition 13 Sales Taxes. Overall, collections are expected to increase 1.6% in 2007-2008 to \$152.4 million and remain at essentially the same level in 2008-2009 at \$152.5 million.

The forecast for the General Sales Tax revenue estimate assumes collections of \$147.9 million in 2007-2008, an increase of approximately 1.8% over the 2006-2007 collection level of \$145.3 million. This reflects actual performance for the first quarter of 2007-2008 and the assumption that growth in the remaining three quarters of 2007-2008 will total only approximately 1%. It should also be noted that a portion of this growth is related to additional revenue from 2006-2007 that had been under-accrued at the end of 2006-2007 and is booked in 2007-2008. The low growth rate projected for the remainder of 2007-2008 was based on a review of current collection trends as well as the assumption that the deteriorating economic environment will impact Sales Tax collections, particularly consumer spending.

For 2008-2009, General Sales Tax receipts are expected to remain at \$147.9 million. While it appears that no increase is built into the estimate, there is an underlying growth rate of 1% assumed for each quarter. This growth is offset by two factors. The 2008-2009 estimate does benefit from an under-accrual from the prior year, which had accounted for a portion of the growth in 2007-2008 but was not part of the base revenues from which the 2008-2009 revenue

# ELEMENTS OF THE GENERAL FUND FORECAST

## REVENUE FORECAST (CONT'D.)

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### **Sales Tax** (Cont'd.)

estimate was developed. In addition, the estimated payment from the State for the “triple flip”<sup>1</sup> payment reflects no growth and assumes a slight negative true-up payment associated with 2007-2008 collections, which brings down the growth for 2008-2009.

Proposition 172 Sales Tax collections (representing the one-half cent tax that is allocated to counties and cities on an ongoing basis for the use in funding public safety programs) are expected to total \$4.5 million in 2007-2008, which represents a slight decline from the actual 2006-2007 collections of \$4.6 million based on activity through the first seven months of 2007-2008. In 2008-2009, collections are projected to remain flat at \$4.5 million.

Through the remaining years of the Forecast in the Sales Tax category, the growth rate is expected to recover slightly, with growth ranging from a low of 3.57% in 2010-2011 to a high of 4.0% in 2012-2013.

### **Departmental Charges and Other Licenses**

The Departmental Charges and Other Licenses categories contain fees and charges imposed by various departments within the City. The most significant revenue sources are from the collection of construction and development-related fees. Revenue collection levels are projected based on City Council-approved cost-recovery policies with the goal of a net-zero impact on the General Fund. When developing the forecast estimates for these categories, the revenues are set at the anticipated collection levels. For 2008-2009, it is assumed that development-related revenues will experience no increase in activity from the estimated 2007-2008 levels. In cases where the development-related revenues are projected to exceed costs, the impacted departments will need to develop budget proposals for incorporation into the 2008-2009 Proposed Operating Budget to increase resources to meet the service demands or to reduce fees. On the other hand, if the projected revenues are not sufficient to cover the base costs, departments will be submitting proposals to reduce costs and/or increase fees to bring projected revenues and expenditures back in line for a net-zero General Fund impact. For 2008-2009, the Building and Public Works Fee Program revenues are projected to be well below the costs, which will require significant budget actions to bring these programs in balance. For the non-development-related fees and charges, the 2008-2009 estimates are based on current collection trends. In the out years of the forecast,

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<sup>1</sup> In March 2005, voters approved Proposition 57, the California Economic Recovery Bond Act, which allowed the State to purchase bonds to reduce the State budget deficit. One aspect of the bond measure, referred to as the “triple flip”, is a complex set of transactions that involve suspending one-quarter of the Sales and Use Tax and replacing the lost revenues with Property Tax revenues. This change will remain in effect until the State’s bond obligations have been satisfied. As a result, the City has been receiving reduced (down 25%) Sales Tax receipts each month. Under the provisions of the State Budget action, the reduced amounts are offset by payments made twice a year, from Property Tax receipts (usually in January and May) that are based on estimated Sales Tax collections for the upcoming year plus a “true-up” from the prior year. The City will, however, continue to record the replacement property tax revenues as Sales Tax receipts as this action is considered a temporary situation.

# **ELEMENTS OF THE GENERAL FUND FORECAST**

## **REVENUE FORECAST (CONT'D.)**

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### **Departmental Charges and Other Licenses** (Cont'd.)

both the Departmental Charges and Other Licenses categories are expected to experience growth of 3.5% annually.

### **Business License Tax**

This category includes General Business License Tax and Disposal Facility Tax. In both 2007-2008 and 2008-2009, General Business License Tax proceeds are expected to reach \$12.6 million. In the Disposal Facility Tax category, collections are estimated at \$13.7 million in 2007-2008, a decrease of 6.9% from the 2006-2007 collection level. Receipts are expected to remain at this level for 2008-2009. In the remaining years of the Forecast, the Business License Taxes category is expected to experience minimal growth of less than 1% per year.

### **Money and Property**

This category consists primarily of interest income. The 2008-2009 estimate for interest earnings in the General Fund and for the other funds where earnings are transferred to the General Fund assumes an average interest rate of 3.41%, applied to an average cash balance of approximately \$240 million for a total collection level of \$8.2 million. This forecast reflects a decrease to the average interest rate yield (down from 4.4%) based on projections provided by the Finance Department, partially offset by an increase in the average cash balance (up from \$210 million), from the assumptions used to develop the 2007-2008 Adopted Budget estimate. Interest transfers from capital and special funds have been adjusted to reflect the various impacts of expected activity and fund balance levels in 2008-2009. These remaining sources in this category are expected to generate \$5.2 million in 2008-2009. In the out years of the forecast, increases ranging from 0.5% to 1.0% are projected.

### **Motor Vehicle In-Lieu**

In 2007-2008, Motor Vehicle In-Lieu collections are expected to reach \$4.8 million based on current collection trends and adjustments for prior year payments. This reflects a significant drop from the \$5.9 million received in 2006-2007. The 2006-2007 figure was larger due, in part, to the booking of two prior year payments for Vehicle License Collection in Excess Fees that totaled approximately \$700,000. Factoring out prior year payments, collections are still tracking below the prior year due to the slowdown in new car sales. This reflects the 8% drop in new car registrations experienced in 2007 and an additional 4% projected drop in 2008 (California Auto Outlook, January 2008). Because activity is expected to improve in 2009, slight growth of 2.0% is projected for 2008-2009, bringing projected revenues to \$4.9 million. In the out years of the forecast, small annual increases ranging from 2.74% to 2.93% are anticipated.

### **Federal Revenue/Other State Revenue**

These categories consist primarily of grant revenues. In the Federal Revenue category, three grants are anticipated in 2008-2009: the Senior Companion Program grant (\$130,000); the

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## REVENUE FORECAST (CONT'D.)

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### **Federal Revenue/Other State Revenue** (Cont'd.)

Retired and Senior Volunteer Program (RSVP) grant (\$92,000); and the Juvenile Justice and Delinquency grant (\$40,000). For State grants, the following three grants are expected in 2008-2009: Public Library Foundation (\$371,000); the California Library Literacy Service grant (\$46,000); and the Waste Tire Enforcement grant (\$185,000). The remaining payments from the State projected for 2008-2009 include the Aircraft Unsecured Payment (\$2.5 million), the Abandoned Vehicles Abatement Program (\$710,000), the Auto Theft reimbursement (\$370,000), the Highway Maintenance Charges (\$287,000), and the Vehicle License Collection in Excess (\$250,000). These other State revenues are generally set at the 2007-2008 Adopted Budget level. The Aircraft Unsecured payment of \$2.5 million is set above the 2007-2008 Adopted Budget level of \$1.5 million because actual collections in 2007-2008 significantly exceeded this level due to efforts by the County to audit these payments. The \$2.5 million figure represents an estimate of the amount of ongoing revenue expected from this source.

### **Gas Tax**

The Gas Tax estimate assumes that collections in 2008-2009 will total \$17.2 million. This collection level is in line with historical tracking patterns for this category. In the out years of the Forecast, the expected growth ranges from a 0.01% in 2009-2010 to 2.25% in 2011-2012.

### **Transient Occupancy Tax**

It is currently estimated that Transient Occupancy Tax receipts for 2007-2008 will total \$9.5 million, reflecting growth of 10.9% from the 2006-2007 collection level. In 2008-2009, a much more moderate growth level of 4% from the 2007-2008 estimate is anticipated, reflecting the impact of the economic slowdown. In the remaining years of the forecast, annual growth ranging from 3.19% to 4.01% is projected.

### **Utility Tax**

Utility Taxes are imposed on electricity, gas, water, and telephone usage. Collections in 2007-2008 are anticipated to end the year at \$81.0 million, representing an increase of 2.4% from the 2006-2007 collection level. In 2008-2009, an overall increase of 2.9% is anticipated and would bring collections to \$83.3 million. In the Electricity and Gas Utility Tax categories, increases of 3% in 2008-2009 are projected based on the electricity rate increases approved in January 2008 and the assumption that Gas rates will also increase slightly. Growth of approximately 5% is anticipated in the Water Utility Tax category based on projected rate increases. Slight growth of 2% in the Telephone Utility category is projected based on projected increases in the cellular phone area.

In the out years of the Forecast, growth ranging from 2.10% to 2.75% annually is expected in the Utility Tax category.

# **ELEMENTS OF THE GENERAL FUND FORECAST**

## **REVENUE FORECAST (CONT'D.)**

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### **Franchise Fees**

Franchise Fees are collected in the Electricity, Gas, Cable, Tow, Commercial Solid Waste, Water, and Nitrogen Gas Pipeline categories. Overall, collections are projected at \$41.1 million in 2007-2008, an increase of 1.8% over the 2006-2007 actual receipts. In 2008-2009, Franchise Fees are expected to increase 1.4% to a total collection level of \$41.7 million. In 2008-2009, growth is projected in the Electricity and Gas Franchise categories (3%), the Cable Television category (3.6%), and the Water Franchise Fee category (5.0%), offset by a projected decline of 2.4% in the Commercial Solid Waste category. The remaining categories are expected to remain at the 2007-2008 estimated level for 2008-2009.

In the out years of the Forecast, Franchise Fee revenues are anticipated to increase from 2.32% to 2.88% annually.

### **Fines, Forfeitures and Penalties**

In both 2007-2008 and 2008-2009, the Fines, Forfeitures and Penalties category is expected to generate \$15.2 million. Collections include a penalty payment of \$539,000 from Garden City Club in 2008-2009 and a final payment of \$45,000 which is due in 2009-2010. In the out years of the Forecast, this category is expected to experience a decline of 1.8% in 2009-2010 due to the elimination of the majority of the Garden City penalty payment. In the remaining years, growth ranging from 0.95% to 1.25% is projected annually.

### **Revenue from Local Agencies**

In 2008-2009, revenue of \$45.8 million is projected from other local agencies, such as the Redevelopment Agency, the Central Fire District, and the County. The largest portion of the Revenue from Local Agencies category consists of reimbursements from the San José Redevelopment Agency (SJRA). The SJRA reimburses the General Fund for the Convention Center lease payment that is projected at \$14.3 million for 2008-2009. Estimated SJRA reimbursements for City service costs for 2008-2009 of \$15.8 million are based on the assumption that ongoing support will remain consistent with current levels. SJRA reimbursements for past capital expenditures (which enable the City to fund the San José Best Program at \$3.0 million) have also been included in the Forecast.

For 2007-2008, Central Fire District payments are expected to end the year at \$5.8 million. Property taxes fund the Central Fire District activities, and those payments for the County areas covered by the San José Fire Department are passed on to the City. Growth of 4.0% is projected for 2008-2009, bringing collections to \$6.0 million.

In 2008-2009, payments from the County of Santa Clara for the first responder advanced life support program (Paramedic Program) are assumed at \$1.8 million as the receipts are based on the annual adjustments approved by the contract with the County. In addition, the City is expected to receive \$1.5 million from the County for the Adult Day Care and Senior Nutrition

# ELEMENTS OF THE GENERAL FUND FORECAST

## REVENUE FORECAST (CONT'D.)

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### **Revenue from Local Agencies** (Cont'd.)

programs. Payments of \$1.8 million from other local agencies are expected to reimburse the City for its CAL-ID program.

Enterprise Fund In-Lieu payments, representing revenue from the Water Pollution Control Plant and Municipal Water System in lieu of taxes, are projected at \$2.4 million in 2008-2009. This figure is well below the 2007-2008 Adopted Budget of \$4.3 million to reflect the first year of a two-year phase-out of this payment.

In the remaining years of the Forecast, the Revenue from Local Agencies category is projected to decrease by 2.54% in 2009-2010, to reflect the second year of the phase-out of the Enterprise Fund In-Lieu payment, and increase in each of the remaining years of the Forecast between 1.50% and 2.30% annually.

### **Other Revenue**

The Other Revenue category consists of miscellaneous revenues received from a variety of sources, including proceeds from the Sale of Surplus Property, cost reimbursements for the Investment Program, Arena Rental, Suite, Parking, and Naming revenues, and reimbursements from the Airport to cover the FMC property debt service payments. Revenue estimates assume continuation of current year activity levels with revisions, where appropriate, for 2008-2009 costs or agreements. The proceeds from the Sale of Surplus Property category has been set at \$100,000 to assume that, at a minimum, the costs of the Real Estate Division related to the sales process will be recovered.

The 2008-2009 estimate for Other Revenue is \$16.0 million. In the remaining years of the forecast, minimal increases ranging from 0.73% to 1.41% annually are projected.

### **Overhead Reimbursements**

The Overhead Reimbursements category includes overhead reimbursements from both operating and capital funds. In 2008-2009, a total of \$35.1 million is projected. This estimate is based on 2007-2008 overhead rates applied against the projected 2008-2009 salaries for those positions for which an overhead rate is applied. The prior year rates have been used because the Finance Department is now stating that it will not be releasing the 2008-2009 overhead rates until sometime in March. When we receive updated rates, revised 2008-2009 overhead projections will be incorporated into the 2008-2009 Proposed Budget. In the remaining years of the forecast, annual increases of 3.5% are assumed reflecting the anticipated cost of living adjustments.

# **ELEMENTS OF THE GENERAL FUND FORECAST**

## **REVENUE FORECAST (CONT'D.)**

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### **Transfers**

The Transfers category is projected at \$47.3 million for 2008-2009. This reflects a drop from the 2007-2008 Adopted Budget estimate of \$49.6 million, primarily due to the elimination of one-time transfers. Upward adjustments to the Airport Crash Fire Rescue and Airport Police Consolidation reimbursements have been assumed in 2008-2009 and the remaining four years of the forecast to reflect cost of living adjustments. The Municipal Water Rate of Return transfer is budgeted at \$445,000 for 2008-2009 and reflects the first year of a two-year phase-out of this transfer. The remaining transfers have been reflected at current year levels, with slight adjustments for costs or payment schedules as necessary. For 2008-2009, the transfer from the Emergency Communication System Support (ECSS) Fee Fund has been set at the 2007-2008 Adopted Budget level of \$23.4 million based on current collection trends. Based on a preliminary analysis of the 2008-2009 ECSS costs, there are sufficient costs to support this level of transfer. This figure may be adjusted as part of the 2008-2009 Proposed Budget after a thorough analysis of eligible costs and revenues generated from the ECSS Fee.

This category is reduced significantly in 2009-2010 due to the potential sunseting of the ECSS Fee. This would result in a loss of \$23.4 million annually.

### **Reimbursements for Services**

The Reimbursements for Services category reimburses the City for actual costs associated with the Deferred Compensation Program and the Maintenance Assessment District Funds. These amounts have been set to recover costs in 2008-2009 of \$592,000, with average increases of approximately 3.5% in the out years of the forecast to reflect anticipated cost of living adjustments.

### **Beginning Fund Balance**

The forecast estimate for available Beginning Fund Balance in 2008-2009 of \$54.2 million is based on the following assumptions:

- A Contingency Reserve balance of at least \$27.4 million will remain uncommitted by year-end.
- A total of \$24.3 million will be achieved from a combination of excess revenue, expenditure savings, and the liquidation of prior-year carryover encumbrances. This assumes that revenues will exceed the budget by 1% and that expenditure savings of 2% will be generated each year.
- The Parks Maintenance Earmarked Reserve will provide \$2.5 million, of which \$1.0 million will be allocated as part of a three-year General Fund balancing plan, \$1.1 million will support the Enhanced Parks Maintenance staffing, and \$333,000 will support Public-Private Partnership efforts. In addition, \$90,000 will be provided from the Building Fee Program Reserve to support Public Works staff that are assigned to the Customer Service Center.

# ELEMENTS OF THE GENERAL FUND FORECAST

## REVENUE FORECAST (CONT'D.)

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### **Beginning Fund Balance** (Cont'd.)

The future year beginning fund balance estimates assume that expenditure savings of 2% and excess revenue of 1% will be generated annually. This would generate fund balance ranging from \$24.9 million to \$27.8 million per year, which is above the \$20.0 million for the unrestricted portion of the balance that was assumed in the February 2007 Forecast. The carried over Contingency Reserve portion is adjusted upward based on the Contingency Reserve allocation from the prior year.

### **One-Time Funding Available**

Not included in the Forecast but available for Council consideration is the **2008-2009 Future Deficit Reserve** of \$7.3 million that was established, per City Council policy, as part of the 2006-2007 Annual Report. This reserve was set aside to fund a portion of the shortfall that was projected for 2008-2009 in the February 2007 Forecast. This reserve is not assumed in the remaining forecast years. However, the amount of funding that has been set aside historically for future year deficits has ranged from a low of \$4.3 million in 2000-2001 to a high of \$18.4 million in 2005-2006. Per City Council policy, a portion of the remaining unallocated funds available at the close of each fiscal year is directed to be used to cover any projected shortfall in the following year based on the Five-Year General Fund Forecast.



# ELEMENTS OF THE GENERAL FUND FORECAST

## EXPENDITURE FORECAST

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### Personal Services

As is our usual practice, the first year (2008-2009) projection for personal services costs in this Forecast has been calculated at a detailed level. An extract of payroll system information as of August 2007 was used as the starting point. This individual position-level information was then reviewed, corrected, and updated by each department to include current vacancies and filled positions, accurate salary step status, as well as any position reclassifications. In addition, 2007-2008 ongoing position reductions and additions were annualized, and projections for all categories of benefit costs in the coming year were made.

Personal services costs continue to account for approximately two-thirds of the General Fund's total costs. The Personal Services category has been broken down into its three major components (Salaries and Other Compensation, Retirement, and Health and Other Fringe Benefits). This display of personal services costs is intended to show how these different elements drive rising personnel costs. For example, even without any salary changes, the other major personnel cost components (retirement and health and other fringe benefits) impact personal services and, particularly in recent years, have been responsible for a large part of the major increases in personnel costs. To provide historical context to the growth in this area, from 2000-2001 to 2007-2008, total average personal services costs grew by 53%, with average salary and other compensation increasing 38% over this period, while retirement costs increased 114% and health and other fringe benefit costs grew by 110%.

For 2008-2009, the total personal services preliminary estimate, as displayed in Section Two of this report, represents a decrease of approximately 0.2% (\$1.5 million) from the 2007-2008 Adopted Budget level. It should be noted, however, that the level of growth shown for personal services costs in the Forecast actually significantly understates the underlying personal services growth for 2008-2009, primarily due to the rebudgets in 2007-2008 and the technical treatment of the Development Fee Program. The 2007-2008 Adopted Budget included a significant amount of Salary Reserve that was rebudgeted from the prior year to address potential prior year salary and benefit adjustments, which are not necessary in 2008-2009. Once those one-time items have been removed from 2007-2008, the underlying growth of personal services is approximately 4.3% in 2008-2009.

Specific factors impacting the elements of the personal services Forecast include:

- The implementation of the retirement rates for the City's contribution for both the Federated and Police/Fire Retirement plans. The Federated and Police/Fire retirement costs reflect the change in the employer contribution rates from 21.98% to 23.56% (Federated), 28.90% to 25.55% (Police), and 31.26% to 28.06% (Fire) as applied to base salaries. As a result, a reduction to expenditures totaling approximately \$5.0 million has been reflected in this Forecast when compared to the costs provided in the prior forecast document. The issue of whether some or all of these unanticipated savings should be considered for use in addressing a portion of the City's unfunded liability associated with post-employment benefits will be addressed in the Proposed Budget;

# ELEMENTS OF THE GENERAL FUND FORECAST

## EXPENDITURE FORECAST (CONT'D.)

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### Personal Services (Cont'd.)

- The annualization of salary compensation and benefit growth from negotiated bargaining agreements in the current year (2007-2008);
- Forecasted new negotiated salary compensation and benefit increases with eight of the thirteen bargaining/employee groups, including Police Officers Association (POA), City Association of Management Personnel (CAMP), Confidential Employees' Organization (CEO), International Union of Operating Engineers, Local #3 (OE#3), Municipal Employees' Federation (MEF), Unrepresented Non-Management (Unit 8), International Brotherhood of Electrical Workers (IBEW), and Executive Management (Unit 99);
- The impact of deleting rebudgeted items in the Salary Reserve, primarily the funding for the retroactive payments due to the employees of the International Association of Firefighters (IAFF);
- The new inclusion of Strong Neighborhoods Initiative (SNI) Program staffing costs in this category as the Office of the City Manager has responsibility for the management of this function. As a result, the SNI Program is now included in the Personal Services and Non-Personal/Equipment categories, which is offset by a reduction in the City-Wide Expenses category where these costs were previously displayed;
- Salary step increases for current employees (an overall 1.5% salary and benefit growth level for the category); and
- Forecasted health rate increases of 10%.

It is important to note that not included in the Personal Services category are Workers' Compensation Claims Payments and Sick Leave Payments Upon Retirement. These costs, which are included in the City-Wide Expenses category, are also considered key expenditure components of the cost of the City's workforce. In 2008-2009, \$15.3 million for Workers' Compensation Claims Payments and \$8.5 million for Sick Leave Payments Upon Retirement have been included in this Forecast.

It should also be noted that due to the mechanism used to represent the desired outcome in fee programs, personal services expenditures in this forecast are further understated by approximately \$7.2 million. The \$7.2 million represents the shortfall that would exist in the development-related fee programs in the Planning, Building and Code Enforcement and Public Works departments if all costs were reflected. These fee programs are intended by the City Council to recover 100% of the cost of development review and inspection and, as a result, costs are reflected in this Forecast at the expected revenue collection level. The Public Works and Building fee programs will be required to develop strategies that will address this \$7.2 million shortfall in the 2008-2009 Proposed Budget.

As with past forecasts, personal services costs in years two through five of this Forecast have been projected on a more global basis, using the detailed costs calculated for the first year as a

# ELEMENTS OF THE GENERAL FUND FORECAST

## EXPENDITURE FORECAST (CONT'D.)

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### Personal Services (Cont'd.)

base, and then growing that base by an overall percentage factor representing expected growth from salary and benefit adjustments. For this Forecast, the out years were projected to inflate at a composite rate of approximately 4.3%. This projected rate of growth is down from the 4.7% presumed in the February 2007 forecast due to refinements in the forecast model for turnover and salary assumptions.

### Non-Personal/Equipment

Non-personal/equipment expenditures for the first year of the forecast have also been calculated at a detailed level. The process utilized by the Budget Office includes adjusting each department's current year budget to eliminate one-time allocations, annualizing all partial-year reductions or additions approved for 2007-2008, and including projected adjustments for specific large non-personal/equipment allocations (e.g., utilities, leases, contracted services, and Police Department vehicle replacement) as described later in greater detail. The resulting 2007-2008 estimates represent a decrease (\$4,477,000) from the current year level. This reflects the net impact of deleting one-time additions and rebudgeted items and annualizing actions included in the 2007-2008 Adopted Budget. In addition, as discussed in the Personal Services section above, funding has been included here for the SNI Program that was previously funded in the City-Wide Expenses category.

Departmental gas and electricity funding for 2008-2009 has been decreased in this Forecast by \$1,372,000 to reflect approved gas and electricity rates, and projected consumption changes from expanded City facilities. This large decrease is primarily due to better information on the actual costs to operate City Hall as 2006-2007 represented the first full year of operations for the new City Hall facility. Previously, engineer estimates and information on projected rates were used to develop the budget for gas and electric utilities for this new facility. For 2008-2009, actual experience and projected rates were used to determine this funding requirement.

Other specific adjustments included in the 2008-2009 non-personal/equipment base include increases for vehicle maintenance and operating costs (\$1,308,000) and contractually required cost of living increases to major contracts. In addition, a 1.65% increase, which represents one-half of the San Francisco-Oakland-San José area consumer price index for the past 12 months, has been applied to eligible expenditures. Eligible expenditures in the non-personal/equipment category are non-centrally determined details, such as supplies, postage, and printing, and expenditures that have not already been inflated for negotiated contracts and agreements. For the out years of the forecast, a growth rate of 2.0% has been assumed from the 2008-2009 non-personal/equipment base level in each of the four years. This projection is unchanged from that assumed in recent forecasts.

### Other Expenditures

The General Fund **Capital Projects** category includes debt service payments for Central Service Yard – Phase I (\$877,000 in 2008-2009). These payments increase to \$1,673,000 in the out

# ELEMENTS OF THE GENERAL FUND FORECAST

## EXPENDITURE FORECAST (CONT'D.)

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### Other Expenditures (Cont'd.)

years as a result of prior budget actions taken in 2007-2008 that impacted both 2007-2008 and 2008-2009. Also included in this category is the continuation of allocations for Arena repairs, unanticipated maintenance of City facilities, and fuel tanks and methane monitoring control and replacement.

As was the case in previous forecasts, continued capital funding for the Replacement of Fire Apparatus is carried in this Forecast. In 2008-2009, the level of funding is \$2.0 million and increases to \$3.0 million in 2012-2013 to fund the current Fire Vehicle Replacement Policy. This is consistent with the previous forecast. Based on City Council action, the Sidewalk Repair Program capital allocation has been eliminated. In 2007-2008, remaining funding of \$683,000 for City support of a sidewalk repair program was eliminated on an ongoing basis and has been removed from all years of this Forecast. Property owners are now responsible for costs to repair their sidewalks.

The City-Wide Expenses program in the first year of the Forecast (2008-2009) represents a net reduction of \$53.0 million from the 2007-2008 level. This large reduction reflects the combined impact of deleting rebudgets (\$39.5 million), one-time grants (\$4.9 million) and other one-time items (\$11.2 million) including large technology improvements of \$7.0 million budgeted in 2007-2008. In addition, the Office of the City Manager has responsibility for the SNI Program. Funding in the amount of \$1.9 million has been reallocated from City-Wide to the Personal Services and Non-Personal/Equipment categories. This category also includes funding for debt service payments for several City facilities. The payments for the Convention Center and FMC Property, which are reimbursed by the Redevelopment Agency and Airport funds, have been adjusted by a net reduction of \$414,000 to reflect the latest payment schedules. Workers' Compensation Claims payments in this forecast range from \$15.3 million in 2008-2009 to \$16.5 million in 2012-2013, which is a reduction of \$2.9 million from the last forecast to recognize the reduction in the number of claims for City employees. Sick Leave Payments Upon Retirement expenditures have been included in this forecast at \$8.5 million for 2008-2009.

The **Earmarked Reserves** category includes a reserve for the Comprehensive General Plan Update (\$200,000). This reserve is entirely offset by revenues collected from a surcharge on development permits. Not included here are any Earmarked Reserves that may remain unspent in 2007-2008, and be rebudgeted to 2008-2009. Some of the larger current Earmarked Reserves include the Development Fee Program Reserves, Workers' Compensation/General Liability Catastrophic Reserve, Enhanced Parks Maintenance Reserve, Salary and Benefits Reserve, Hayes Mansion Conference Center Line of Credit Reserve, Future Capital Projects (FF&E) Reserve, Neighborhood Investment Fund Reserve, and Economic Uncertainty Reserve.

As in previous years, the Equipment category includes a general equipment reserve of \$100,000 for subsequent allocation in the 2008-2009 Proposed Budget. Similarly, \$250,000 is assumed annually for computer equipment and automation projects also for subsequent allocation during the Proposed Budget process.

# ELEMENTS OF THE GENERAL FUND FORECAST

## EXPENDITURE FORECAST (CONT'D.)

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### Other Expenditures (Cont'd.)

The **Transfers** category includes funding for Communications Center debt service as required under the terms of financing used for construction of this facility (\$2.4 million in 2008-2009); funding to cover a portion of the debt service payments for the Hayes Mansion Conference Center (\$4.4 million per year) and Rancho del Pueblo and Los Lagos Golf Courses (\$1.25 million per year); and payments in accordance with the San José Arena Management (\$1.5 million per year in years one through four) for Arena repairs and capital enhancements. All of the debt service and maintenance and operations costs for the Hayes Mansion Conference Center and golf courses are funded in the Community Facilities Revenue and Municipal Golf Course Funds, however, revenues in those funds are not projected to be sufficient to completely cover these costs. The payments for Arena repairs and capital enhancements are in compliance with the San José Arena Management Agreement Extension from 2009-2018. The first year of the Forecast (2008-2009) is the first year of these required payments, as assumed in prior forecasts. In 2012-2013, an additional \$1.25 million is necessary to pay for the City's share of the \$16.5 million of improvements at the Arena, as approved by City Council in May 2007. In addition, revenue offset payments for the Camden Lifetime Activities Center debt service (\$200,000 in 2008-2009), Fiber Optics loan repayment, and various Maintenance Assessment Districts for the General Fund's share of landscape services in those areas are included.

A **Vehicle Replacement/General Fleet** allocation of \$1.6 million per year is included to fund a vehicle replacement schedule for the General Fleet. This is a reduction of \$150,000 from the previous forecast to reflect a budget action taken in 2007-2008 on an ongoing basis for the replacement of vehicles in the General Fleet.

In 2008-2009, **Vehicle Replacement/Police Fleet** funding is carried in the Non-Personal/Equipment category (\$2.8 million). Due to the large variation in funding levels necessary to fund the replacement of Police vehicles over the five-year period, the incremental costs necessary to ensure that replacement schedules for the marked, covert, and unmarked Police fleet are met are shown as a separate line item. In this Forecast, they range from an increased need of \$900,000 in 2010-2011 to a reduced need of \$400,000 in 2012-2013.

### Contingency Reserve

Per City Council policy, the 2008-2009 Contingency Reserve is projected at the level necessary to comply with the City Council policy to maintain a 3% Contingency Reserve (\$28.5 million). Amounts necessary to remain in compliance with that policy are also included in each of the remaining four years of the Forecast.

### Committed Additions to the Base General Fund Forecast

In this Forecast, projected additions to the base expenditure level have been included as **Committed Additions**. The **Committed Additions** are additional expenditures to which the City is considered to be committed by prior City Council action, such as the costs related to maintaining and operating capital projects previously approved by the City Council. Typically,

# ELEMENTS OF THE GENERAL FUND FORECAST

## EXPENDITURE FORECAST (CONT'D.)

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### Committed Additions to the Base General Fund Forecast (Cont'd.)

the Forecast Base Case, considered most closely by the City Council, includes ongoing program costs plus committed additions.

The following committed additions are included in the 2009-2013 Forecast and explained in more detail in a later section of this document.

Increased costs for street lighting and maintenance of scheduled **Street Improvements** (\$227,000 in 2008-2009) are included as a committed addition.

**New Parks and Recreation Facilities Maintenance and Operations** costs (\$466,000 in 2008-2009) are included at the levels necessary to support the additional costs of maintaining and operating new park facilities that were included in the City's latest Five-Year Capital Improvement Program and those that are being developed by other agencies. Examples of projects include Martin Park Expansion in 2009-2010, Emma Prusch Park Back Acreage Development (2010-2011) and Mabury Park/Commodore Children's Park (2010-2011).

Three new items, **Defibrillator Replacement Program** (\$1,631,000 in 2009-2010), **Retrofit of Diesel-Powered Vehicles** (\$319,000 in 2008-2009), and **Infrastructure Maintenance of Annexed County Pockets** (\$85,000 in 2008-2009) have been included. Based on the product life cycle, it is necessary to replace cardiac monitors and defibrillators in 2009-2010. Recent State legislation requires the City to retrofit diesel-powered vehicles in an effort to reduce the use of fossil fuels and the release of harmful emissions. A phased program is assumed whereby 60% of diesel-fueled vehicles will have Best Available Control Technology by December 31, 2009, and the remainder by December 31, 2011. Beginning in 2006-2007, the City began a proactive process to annex unincorporated islands of less than 150 acres of County land within the City of San José Urban Service Area. Approximately 40 miles of public streets and related infrastructure in these islands, such as streetlights, sidewalks, traffic signs, roadway markings, and trees will require ongoing maintenance, repair, and rehabilitation work. These are new funding requirements that were not included in the February 2007 Forecast.

The approved bond measures from the elections of November 2000 and March 2002 will result in new and expanded library (**Measure O**), park (**Measure P**), and police and fire (**Measure O**) facilities and will require additional **Maintenance and Operations** funding (\$577,000 in 2008-2009). Some of the new facilities scheduled to open during this forecast period include: the South San José Police Substation, Driver Safety Training Center, Fire Station 37 (Silver Creek/Yerba Buena Road), Willow Glen and Santa Teresa Branch Libraries, and Roosevelt and Solari Community Centers.

# ELEMENTS OF THE GENERAL FUND FORECAST

## OPERATING MARGIN

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Base Case expenditures, including committed additions, increase from \$878.3 million in 2008-2009 to \$1.02 billion in 2012-2013, for an average growth rate each year of approximately 4.1%. General Fund sources (including Beginning Fund Balance), on the other hand, total \$856.0 million in 2008-2009, and grow to \$950.5 million in 2012-2013, an average growth rate of only 2.8% annually.

Compared to the February 2007 Forecast, expected growth rates in the out years of the Forecast for expenditures have changed slightly, decreasing from 4.4% to 4.2% for the comparable period of 2009-2010 through 2011-2012. This decline was largely due to the impact of the new retirement rate contributions for the two retirement systems. Expectations for overall growth rates for revenue collections during the comparable three-year period have on the other hand decreased from 2.9% to 2.3%. This reflects lower growth assumptions in economically related revenue categories such as Sales Tax.

The Base Case with Committed Additions General Fund Forecast projects a shortfall in the first year (2008-2009) of \$22.3 million. This is lower than both the November 2007 Preliminary Forecast shortfall estimate of \$24.8 million, and the February 2007 Forecast shortfall of \$25.5 million for 2008-2009. As shown on the attached chart, this assumes that all of the \$5.0 million in savings in City retirement costs, compared to the prior forecast, are applied to reduce the shortfall. An alternative that will be considered is to apply some or all of these unanticipated savings to address a portion of the City's share of the annual required contribution for post-employment benefits. This approach would have to be evaluated in terms on the broader strategy to address this issue. The City Manager will bring forward a recommendation regarding this issue as part of the Proposed Budget. If all of the retirement cost savings were set aside for that purpose, the projected shortfall would increase to \$27.3 million.

The following table shows how the projected shortfall has changed in the most recent forecasts. The incremental shortfall assumes each preceding deficit is solved completely with ongoing solutions in the year it appears. Each of the four out years of the Forecast is shown in the table, along with a comparison with the increments projected for those years in the February 2007 Forecast and the preliminary 2008-2009 update provided to the City Council in November 2007.

# ELEMENTS OF THE GENERAL FUND FORECAST

## OPERATING MARGIN (CONT'D.)

<b>Base Case with Committed Additions</b> <b>Changes in Operating Margin</b> <b>2009-2013</b> <b>(\$ in Millions)</b>					
	<b><u>2008-2009</u></b>	<b><u>2009-2010</u></b>	<b><u>2010-2011</u></b>	<b><u>2011-2012</u></b>	<b><u>2012-2013</u></b>
<b>February 2007</b>	(\$25.54)	(\$34.28)	(\$3.59)	(\$7.80)	N/A
Incremental Surplus/(Shortfall)					
<b>2007-2008 Adopted Budget Impact</b>					
Incremental Surplus/(Shortfall)	(\$1.28)				
<b>Revised Forecast</b>	<b>(\$26.82)</b>	<b>(\$34.28)</b>	<b>(\$3.59)</b>	<b>(\$7.80)</b>	<b>N/A</b>
<b>November 2007</b>					
Incremental Surplus/(Shortfall)	(\$24.82)	(\$41.78)	(\$2.36)	(\$6.36)	\$3.21
<b>February 2008</b>					
Incremental Surplus/(Shortfall)	(\$22.33)	(\$42.52)	(\$5.49)	(\$4.73)	\$2.50
<i>Incremental Shortfall w/o Retirement Rate Impact</i>	(\$27.33)	(\$42.52)	(\$5.49)	(\$4.73)	\$2.50
<i>Incremental Shortfall w/ECSS Fee Extended</i>	(\$22.33)	(\$19.12)	(\$5.49)	(\$4.73)	\$2.50
<i>One-time Funding Available</i>	\$7.27	N/A	N/A	N/A	N/A

In the February 2007 Forecast, an incremental shortfall of \$25.54 million for 2008-2009 was projected. This figure was based on the assumption that the entire 2007-2008 shortfall would be solved with ongoing actions. However, the 2007-2008 Adopted Budget included a combination of ongoing and one-time solutions. The carryover impact of those one-time measures is reflected in the 2007-2008 Adopted Budget Impact incremental shortfall of \$1.28 million and, when combined with the previous shortfall anticipated for 2008-2009, would result in a deficit of approximately \$26.82 million in 2008-2009.



## ELEMENTS OF THE GENERAL FUND FORECAST

### OPERATING MARGIN (CONT'D.)

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In November 2007, staff prepared a Preliminary Five-Year General Fund Forecast incorporating the final 2006-2007 actual performance and the first few months of activity in 2007-2008. In that Preliminary Forecast, the General Fund deficit for 2008-2009 was reduced from \$26.82 million to \$24.82 million. This slight downward adjustment was the net result of a number of upward and downward adjustments to the City's many General Fund revenue and expenditure categories.

For the February 2008 Forecast, staff completed an in-depth review of anticipated revenues and expenditures for 2008-2009 and the remaining four years of the forecast period. Based on this updated information, a 2008-2009 General Fund shortfall of \$22.3 million is projected, a net decrease of \$2.5 million from the November 2007 figure. The reduction reflects net downward expenditure adjustments of \$13.0 million, partially offset by a net revenue reduction of \$10.5 million. As discussed above, if the benefit from the lower retirement contributions was not factored into the Forecast, this would increase the deficit by \$5.0 million in 2008-2009 to \$27.3 million. A recommendation regarding whether some or all of these unexpected savings should be set aside to address the City's portion of the annual required contribution associated with post-employment benefits will be included in the City Manager's 2008-2009 Proposed Budget.

The economically sensitive revenue estimates have been adjusted downwards based on the worsening economic conditions. The downward adjustment to the Sales Tax category accounted for almost half of the decline, with a reduction of \$4.7 million. Other categories impacted include Property Tax, Use of Money and Property (interest earnings), and Motor Vehicle In-Lieu payments. On the expenditure side, almost 40% of the reduction was the result of lower retirement rates based on the latest actuarial studies. The remaining savings were based on a more in-depth review of the base costs.

The second year of the Forecast (2009-2010) has a sizeable deficit of \$42.5 million. The large spike in the shortfall is based on the presumption of a sunseting of the Emergency Communication System Support Fee, with a resulting loss of \$23.4 million in revenue that year. As also shown in the above table, should the Emergency Communication System Support Fee be extended, the shortfall in that year would be reduced to \$19.1 million.

The variances in the three out years are minimal, ranging from a deficit of \$5.5 million to a surplus of \$2.5 million in the last year of the Forecast. The persistent shortfalls reflect the fact that revenue growth is generally projected to continue to lag behind expenditure growth. In the final year of the Forecast, the surplus of \$2.5 million reflects less than 1% of the projected expenditures in that year of \$1 billion.